

Directors' Liability to Third Parties under Article 191 of the PRC Company Law 2023

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Abstract

This study discusses the new provisions of Article 191 of the the Company Law of the People's Republic of China, as amended in 2023, on the liability of directors to third parties. The study first analyses the trust fund theory as the jurisprudential basis for directors' liability to third parties, pointing out that directors, as trustees of the company's capital, are required to assume fiduciary obligations to creditors. The study then points out the deficiencies of Article 191, including the lack of a hierarchical liability arrangement and the lack of clarity on how the liability of directors and the company for the losses of third parties is to be shared. The study proposes that the principle of differentiation of directors' liability to creditors should be established, and their liability to third parties should be reduced according to the status and salary level of the directors in turn. At the same time, it is suggested that directors should be jointly and severally liable for direct damages, while they should be supplementally liable for indirect infringements, so as to balance the interests of all parties and maintain the stability of the corporate governance structure.

Keywords: Directors' Liability, Third Party Indemnity, Trust Fund Theory, Liability Sharing

Introduction

Directors, supervisors and senior executive are important subjects in corporate governance and commercial transactions, and the liability of directors is a core issue in the legal relationship of companies, and how to determine their liability is related to the improvement of the business environment as well as the civil and commercial legal system(Ye,2021;Zhu,2011).However, as to whether the directors, supervisors and senior executive personnel are directly liable for damages to the third party (hereinafter referred to as 'third party liability'), the legislation as well as theories used to take a negative view. The traditional company law theory denies the third-party liability of directors, and considers that there is no direct legal relationship between directors and third parties(Zhao,2006).The positive doctrine of civil law also holds that the acts of directors are regarded as the acts of the legal person and therefore the directors are not liable to third parties, but the legal person may recover from the directors after it has incurred liability(Wang, 2018;Li,2022).

However, with the development of theory and practice, there is an increasing judicial demand for third parties to sue the company and directors for joint and several liability, while at the same time, the circumstances under substantive law regarding directors' liability to third parties have become increasingly fragmented. In response to these changes, the Company Law of the People's Republic of China (PRC Company Law 2023), as amended on 29 December 2023, added a new Article 191¹, which explicitly provides for the liability of directors and senior executive to third parties.

The motivation for this study stems from the significant shift in corporate law towards recognizing directors' liability to third parties, which represents a departure from the traditional legal stance. This change necessitates a thorough examination of the new provisions to ensure they are effectively implemented and balanced with the interests of all stakeholders. By addressing the shortcomings of Article 191 and proposing practical improvements, this study aims to contribute to the ongoing development of corporate governance and legal frameworks in China.

The contribution of this study lies in its innovative application of the trust fund theory to explain directors' liability to third parties, providing a robust theoretical foundation for interpreting Article 191. Additionally, the study offers specific recommendations to differentiate directors' liability based on their status and responsibilities, and clarifies the division of liability between directors and the company. These insights not only enhance the clarity and predictability of the law but also promote a more equitable and efficient corporate governance structure, ultimately safeguarding the legitimate rights and interests of third parties and directors alike.

The Article 191 of the PRC Company Law 2023 not only marks an important step in the area of directors' liability to third parties in China's company law, but also provides a new legal framework for corporate governance and commercial transactions. However, this new provision faces a number of challenges in its implementation, such as the lack of hierarchical arrangements for liability and the lack of clarity on how liability is shared. This study will provide jurisprudential support for directors' liability to third parties by introducing the trust fund theory and put forward specific suggestions for improvement, with a view to providing guidance for judicial practice, optimising the corporate governance structure, protecting the legitimate rights and interests of third parties and promoting the healthy and stable development of the economy.

Theoretical Basis of Director's Liability to Third Parties

The trust fund theory can provide a legal basis for explaining the liability of directors to third parties and can form the theoretical basis for interpreting Article 191. In the early days of Anglo-American company law, directors' fiduciary duties to investors in trust property arose from their status as fiduciaries (Walsh, 2002). After corporate personality is legally recognised, the object of directors' fiduciary duties is shifted from investors to the company (Guo, 2024). However, the duty of fiduciary duty has never been extended to other third parties in traditional doctrine, and its content includes only the duty of care and the duty of fidelity to

¹ Article 191 Where any director or senior executive causes any damage to any other person in the performance of duties, the company shall be liable for compensation. If any director or senior executive is intentional or has gross negligence, he/she shall also be liable for compensation. (Company Law of the People' s Republic of China, 2023)

the company and the shareholders (Palmiter, 1989). By the mid to late 20th century, however, directors' obligations had undergone an expansive transformation, with judges conditionally recognising directors' liabilities to the company's creditors in a number of closed companies and corporate insolvency situations in their judgements². In the Australian case of *Kinsela v. Russell Kinsela Pty Ltd.*³, the judge noted that where a company is insolvent, the interests of creditors must intervene, and they have the power to extinguish the rights of the shareholders' meeting and the board of directors to dispose of the company's property through the mechanism of liquidation. In effect, the assets of the company at that point are no longer the assets of the shareholders, but of the creditors (Zhang, 1998). With the increasing separation of ownership and management, director behaviour has been found in practice to be a causative factor in the impaired solvency of the company and the occurrence of unfair settlements, and the trust fund theory has developed into a widely used theoretical tool for creditors to seek recourse to directors' liabilities, with the path of the theory requiring that directors, as trustees of the company's capital, need to be held to a fiduciary duty to the creditors. At this point, the trust fund theory has evolved to mean that directors, in place of shareholders as the proprietors of the company, have a fiduciary position in relation to the trust fund that is the company's capital, and as such, have a fiduciary duty to ensure that the company's debts are effectively satisfied by the company's capital (Otteson, 2003).

The trust fund theory, confirmed by the United States Supreme Court, has been propelled to national prominence, becoming the basis of decisions and influence in countless judgements (Norwood and Beveridge, 1994), and has been absorbed and practiced by overseas enactments⁴ and jurisprudence⁵. At the same time, although civil law countries lack the tradition of trust law, but for enterprises in the verge of bankruptcy, such as Germany directly through the directors to bankruptcy filing obligations, the directors of this stage of the responsibility to creditors to become a culture (Hu, 2017), in fact, absorbed the theory of the trust fund theory in the design of the director's responsibility and creditor rights and interests of the protection of the theoretical essence of the trust fund theory.

Shortcoming of Article 191

Lack of Hierarchical Arrangement in Director's Liability

Although Article 191 of the PRC Company Law 2023 breaks through the standardised scenario of the third party liability of directors and senior executive, it only makes general provisions on the liability of directors to third parties, and does not form a hierarchical arrangement. This, to a certain extent, obliterates the individual differences among directors due to their status, job requirements, knowledge and ability, and personalities (Zeng, 2021). Although directors are the de facto information controllers of the company, the status and role of different directors vary greatly, and their control ability, degree and scope of control are not the same (Cao & Hong, 2021). For example, in the same case of reviewing the relevant information materials of the company, the executive directors have access to the first-hand information, while the independent directors often have access to the second-hand materials processed by the executive directors or the management, resulting in insufficient basis for

² *Francis v. United Jersey Bank*, 87 N.J. 15, 432 A.2d 814 (1981).

³ *Kinsela v. Russell Kinsela Pty Ltd.*, 10 ACLR 395 (1986).

⁴ For example, section 214 of the Insolvency Act 1986 ('Insolvency Act 1986') sets out the rules relating to the need for directors to have regard to the interests of creditors on the verge of insolvency and in the event of insolvent liquidation.

⁵ According to scholars, since the 1970s and 1980s in the UK and many other common law countries such as Ireland, Australia, New Zealand and Singapore, there has been a significant amount of jurisprudence on the need for directors to take creditors' interests into account in the fulfilment of their duties when a company is de facto insolvent or on the verge of insolvency (Keay, 2015).

decision-making, and it would be obviously unfair if they were to bear the same responsibility as the executive directors who run the daily affairs of the company.

Different types of directors have different liability capabilities, and if they are held equally liable, directors with less power and worse remuneration will be held more liable, which is contrary to the concept of consistency of power and responsibility. Therefore, it is necessary to differentiate the compensation standard for directors to balance the interests of directors.

Ambiguity in the Division of Liability between Directors and the Company

Although Article 191 of the PRC Company Law 2023 specifies the liability of directors to third parties, it does not specify the manner in which liability is to be shared between the director and the company, i.e., whether the director is to be jointly and severally liable with the company or is to be held liable for supplementary liability in the event that the company is unable to fully indemnify the third party (Guo, 2024). This ambiguity may lead to different understanding and application in judicial practice, affecting the uniformity and predictability of the law. If the director is jointly and severally liable with the company, it may expose the director to excessive pressure to indemnify, especially for those directors who have less influence in the company's decision-making, which may not only frustrate his or her motivation to perform the duties of his or her office, but also lead to the director being overly cautious, which may affect the normal operation of the company. On the contrary, if the director only bears supplementary liability, it may reduce the burden of the director to a certain extent, but at the same time, it may also reduce the binding effect on the director's behaviour, which is not conducive to the protection of the legitimate rights and interests of third parties. Therefore, it is of great significance to clarify the manner of sharing liability between the directors and the company in order to balance the interests of all parties and optimise the corporate governance structure.

Recommendations for Improving Article 191

Although Article 191 of the PRC Company Law 2023 is of great significance in theory and practice, there are still many deficiencies in its implementation, such as the absence of hierarchical arrangements for liability and the lack of clarity in the manner of sharing liability. These deficiencies not only affect the uniformity and predictability of the law, but may also have a negative impact on the motivation of directors to perform their duties. Therefore, it is necessary to further improve Article 191 to ensure its effectiveness and fairness in practical application. Several specific suggestions for improvement are made below.

Establishing a Differentiated Principle of Director's Liability to Creditors

In view of the inadequacy of Article 191 of the PRC Company Law 2023 in terms of the hierarchical arrangement of liability and the manner of sharing liability, this study proposes to first establish the principle of differentiation of directors' liability to creditors. This principle is proposed to address the problem of non-differentiated liability of directors under the current legal framework and to ensure that the liability of directors is commensurate with their status, duties and salary levels in the company, so as to achieve consistency of power and responsibility and to provide incentives for directors to perform their duties more actively, while at the same time protecting the legitimate rights and interests of third parties. Specifically, the implementation of the principle of differentiated liability will help to avoid the situation where directors' motivation to perform their duties is frustrated by excessive

liability, while at the same time preventing the problem of ineffective restraint of directors' behaviour due to too light a liability. Through the introduction of this principle, it can provide clearer guidance for judicial practice, reduce ambiguity and uncertainty in the application of the law, further optimise the corporate governance structure and enhance the efficiency and transparency of corporate governance.

In fact, the PRC Company Law 2023 has begun to differentiate the identity of directors, but the consideration of individualised differences of directors is not reflected in the liability of directors under Article 191, but still shows the trend of non-differentiated liability, which may be an incentive for some directors to imbalance the power and responsibility of the incompatible problem. One of the harshness of joint and several liability is in the total liability of a single responsible person, which creates a path of dependence on a single defendant in the litigation, and it is often difficult to clearly and specifically delineate the attribution of liability among the directors(Si,2024).

In designing the standard of directors' liability, particular attention must be paid to the differences between directors. Ideally, the directors of the decision-making matters for each express their views, and then according to the resolution rules to make a resolution. Director's individual behaviour through the board of directors of the joint resolution of the act of embodiment, the directors collectively responsible for the joint resolution of the act of legislation in accordance with the collective decision-making on the directors' liability for the determination of the idea of non-differentiation, it is by the collective decision-making decision-making rationality(Jiang,2019), but the fact is that the collective decision-making did not play the role of the rationality of the role of the collective decision-making.As most companies in China are in a relatively centralised system, especially small and medium-sized enterprises (SMEs) and unlisted companies with highly concentrated shareholdings, the beneficial owner has absolute control, shareholder democracy is in name only, and centralisation of power has become the norm. At the same time, directors are marginalised, and a deliberative atmosphere in an ideal state seems difficult to achieve, with most directors under pressure to follow the directors representing the interests of the controlling shareholders in exercising their voting rights. In the case of controlling shareholders controlling the board of directors, the so-called collective rational wisdom in decision-making is only the 'one-word hall' of controlling shareholders(Zeng,2022).

Therefore, the differentiation of directors' liabilities will force the proposing directors to actively perform their duties and conduct in-depth discussion on the resolution so as to reduce or exempt the directors' liabilities. The differentiation of directors' liability may be based on the principle of equalisation of payments. This principle suggests that high pay calls for high competence and that the level of competence of directors should be commensurate with their remuneration. The principle of equilibrium of payments has an affinity with other principles, such as the correlation between the level of remuneration and the company's expectations of directors, which points to an increase in the level of competence. Since there are big differences in the control power of different types of directors over the company's operation and management, the real situation should be fully considered when designing the system of director's liability to third parties, so that the size of the director's power and the ability to meet the liability. Directors often have different control over the management decision-making power due to their different positions. With the size of control over the

company, the salary level of the standard can be divided into three categories of directors, respectively, the chairman of the company, internal full-time directors and external part-time directors, whether it is the status of the director, the control of the company's insider information or business management, or the participation in the company or remuneration allowance, the three types of directors are in order of decreasing. The chairman of the board of directors is often more likely to take advantage of his position to abuse his power and greatly harm the interests of the company; inside directors mainly manage the affairs of the company, generally signing and confirming the board of directors' resolutions or financial reports to ensure the authenticity of the documents; and part-time directors often do not devote themselves to the operation and management of the company, and their ability to obtain information and its channels is very limited, which leads to the weakness of the monitoring power. In practice, the average annual allowance of independent directors is only RMB 80,000 yuan(Liu,2022). If independent directors are required to shoulder the same responsibilities towards third parties as the aforesaid directors, their liabilities for compensation will certainly be aggravated, thus triggering a 'wave of resignation'. Therefore, in terms of legislation, the liability of the third party of a director should be reduced in accordance with the status and salary level of the director.

Differentiating Liability for Direct and Indirect Damages

In order to further refine and clarify the specific content of directors' liability to third parties, this study proposes to classify the damaging acts of directors, distinguishing between directly damaging acts and indirectly damaging acts, and stipulating different ways of assuming liability respectively. This categorisation not only helps to define the scope of directors' liability more precisely, but also protects the legitimate rights and interests of third parties while avoiding the imposition of unreasonable and excessive liability on directors. Specifically, there are significant differences between direct and indirect damaging behaviour in terms of the mechanism of damage transmission and the subject of liability, and therefore need to be treated separately. These two types of detrimental acts and their corresponding modes of liability will be discussed separately below.

Joint Liability for Direct Damages

Acts of directors damaging the rights and interests of third parties can be classified into two situations, namely, direct infringement and indirect infringement, according to the different mechanisms of damage transmission. Among them, the direct infringement refers to the director himself or the director manipulates the company to directly infringe the interests of the third party in the course of the director's execution of his duties, in which the loss of the third party does not presuppose that the company has been harmed, and the mechanism of damage transmission is 'director - third party'. The main situations usually cover: direct infringement by the company; misrepresentation by the company; fraudulent insolvency by the director when the company is on the verge of bankruptcy or insolvency; and negligence of the director in exercising the obligation of insolvency liquidation(Wang,2017).

In the case of direct damages, the abusive behaviour of the directors directly causes damage to the interests of third parties, and their behaviour has strong externalities, so it is reasonable to require the directors and the company to bear joint and several liability for the losses of third parties. From the perspective of the directors, the assumption of joint and several liability can impose discipline on the group of directors who are at fault, sanctioning

the 'group organisational breach of trust'(Liu,2023), and in addition, it can provide predictability for the directors' business activities, deterring potential abuses by the directors, and forcing the group of directors to operate in a prudent and self-disciplined manner. From the perspective of the third party, this can, on the one hand, increase the probability that the third party group as a whole will be fully compensated, and on the other hand, provide a direct legal basis for third party litigation, and incentivise creditors to defend their own rights and interests through litigation in a timely manner.

Supplementary Liability for Indirect Damages

Indirect damage refers to the behaviour of directors who indirectly harm the interests of third parties through damaging the interests of the company, and the interests of third parties are harmed due to the undue impairment of the company's liable property, and the mechanism for the transmission of interests is 'director-company-third party'. The common situation is that the director is liable to the company for breach of fiduciary duty, and the company's creditors are subrogated to the claim. In the case of indirect damages, the director's duty behaviour firstly causes damages to the company's interests, and then leads to the third party's interests, and the director's duty slack behaviour is not the direct cause of the third party's damages. The traditional theory of corporate organs holds that the internal nature of the directors should be upheld at this time, and that the directors should not be held liable, but only the company should be held liable to the creditors. Out of the consideration of preventing the director from abusing his power and protecting the third party, the design of the legal system expands the director's original fiduciary duty to the company to the third party, and requires the director to bear the corresponding liability to the third party. Therefore, at this time, it should be prudent to recover the liability of the directors, so as not to increase the operating pressure of the directors. Supplementary liability, as a new form of liability different from joint and several liability(Liang,2015), means that when the same tort produces two overlapping claims for compensation, when the compensation of the first obligor is insufficient to fully fill the damage, the obligor in the second place can be requested to provide compensation(Zhang,2010). The fundamental purpose of supplementary liability is to limit the scope of tort liability and to balance the rights and interests of the victim, the directly liable person and the supplementary liable person(Ma,2021). If the damage caused by the director to the creditor is only indirect, he should only bear the corresponding supplementary liability, and the director's liability should be inferior to the company's liability, with the company as the first obligor of the liability, and the director as a supplement to the company's compensation for the insufficiency of the liability(Li,2024).

Conclusion

In summary, the introduction of Article 191 of the PRC Company Law 2023 is an important milestone in the development of the theory and practice of company law, marking an important step forward in the field of directors' liability to third parties in China's company law. However, this study still faces many challenges in its concrete implementation, such as the lack of hierarchical arrangement of liability and the unclear way of liability sharing. This study provides jurisprudential support for directors' liability to third parties by introducing the trust fund theory, and proposes specific suggestions for differentiated liability principles and liability sharing methods. These measures aim at balancing the interests between directors and third parties, protecting the legitimate rights and interests of third parties and avoiding directors' enthusiasm in performing their duties due to excessive liability, so as to

maintain the stability and effectiveness of the corporate governance structure. In the future, with the accumulation of relevant judicial interpretations and practice cases, it is expected that China's company law will continue to improve in the field of directors' liability to third parties, providing more solid legal protection for corporate governance and commercial transactions.

This study is of great significance at both the theoretical and practical levels. From the theoretical point of view, this study discusses in depth the applicability of the trust fund theory in the director's liability to third parties, expanding the boundaries of the traditional company law theory. By analysing the role of the director as a trustee of the company's capital, this study provides a new perspective for understanding the director's fiduciary duty to third parties and enriches the corporate governance theory system. In addition, the proposals of differentiated liability principles and liability sharing methods put forward in this study provide new ideas and methods for the refined study of directors' liability in company law, and help to promote the further development of company law theory.

From the practical level, the study is of great practical significance for optimising the corporate governance structure and protecting the legitimate rights and interests of third parties. By clarifying the way of responsibility sharing between the director and the company, this study provides specific guidance for judicial practice, which helps to reduce the ambiguity and uncertainty in the application of law. At the same time, the proposal of the principle of differentiated liability can motivate directors to perform their duties more actively and improve the efficiency and transparency of corporate governance. In the current context of China's economic transformation and the deepening of the rule of law, the study not only helps to improve the level of corporate governance, but also provides strong legal support for the creation of a fairer and more transparent business environment and promotes the healthy and stable development of the economy.

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